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Living with Lower for Longer

Introduction

It is not often that I get to speak to a room full of economists and, believe it or not, I consider it a privilege. People say that economists can never agree on anything, but I suspect that we can agree on at least one thing. What is the number one issue that people ask economists about today? It is ultra-low interest rates.

You probably get questions from both sides, just as I do. Young folks with mortgages regularly thank me for keeping interest rates low. When I think about how much cumulative interest I have paid in my lifetime, it is no wonder that they are grateful. But I also hear from people, especially retirees, who are unhappy because they have saved their whole lives and are getting very little income from those savings today.

Now, it is natural to give central banks the credit—or the blame—for ultra-low interest rates. Low rates have been with us since the global financial crisis. The G7 central banks implemented coordinated interest rate cuts in 2008—a sign of just how serious the situation was. Some of the hardest-hit economies, such as the United States, Europe and Japan, implemented unconventional policies to ease monetary conditions further. Without these efforts, the global economy could have fallen into a second Great Depression.

We avoided that fate. But since that time, policy rates have generally remained extremely low, mainly because the economic headwinds that the crisis created have been slow to fade. Some central banks have even gone to negative interest rates, a bizarre concept for many, and bond yields across the curve are also ultra-low. In fact, more than US$10 trillion of government debt is currently trading with a negative yield.

As economists, though, we can also agree that this is about much more than monetary policy. There are big, long-term, global forces acting on interest rates, and people need to understand them better. Senior Deputy Governor Carolyn Wilkins spoke about this same topic last week in London, focusing on the implications for financial stability. Today, I'm going to focus on the

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macroeconomic and monetary policy aspects of ultra-low rates and conclude with some thoughts on how other policies fit into the matter.

Forces Acting

As economists, we naturally think of nominal interest rates as a combination of expected inflation and the real interest rate. Under Canada's inflation-targeting regime, inflation expectations have been very well anchored, even during the global financial crisis and subsequent recession. It follows that a decline in real interest rates is the issue at hand, and a drop in the real neutral rate is a big part of this.

The real neutral rate is a theoretical concept that can't be directly measured, and central banks don't control it. But it is extremely important to understand: it is the inflation-adjusted risk-free interest rate in an economy—the real interest rate that is neither stimulative nor contractionary when an economy is operating at full capacity without cyclical forces at play, thus balancing desired savings and investment. Presently, Bank staff estimate that the real neutral rate falls into the range of 0.75–1.75 per cent, which translates into a range for the nominal neutral rate of 2.75–3.75 per cent. This is down from a range of 4.50–5.50 per cent in the pre-crisis period.

The most important force pushing the neutral rate down has been a steady decline in the potential growth rate of the economy. In turn, this decline is being driven primarily by the aging of our population, which is slowing the rate of growth of the labour force.

In effect, the baby boomers boosted potential economic growth significantly, starting in the 1960s. Since that force has been in place for some 50 years, it is easy to think of that boost as lasting forever. But in a demographic sense, it was temporary. Those folks have been entering retirement for the past few years, and potential economic growth has been slowing as a direct result.

There are other forces acting, of course, including rising global savings rates as developing countries grow to represent a bigger share of global GDP. At the same time, global investment spending has moderated, in part because of lower potential economic growth; firms need to invest less than they did in the past to sustain that lower potential output. Technological change is also playing a role. But this combination of higher savings and lower investment means that the price of borrowing those savings in order to invest—the neutral interest rate—has ground even lower.

Today, those forces seem permanent to people, but of course nothing is really permanent. Just as the 50-year boost to potential growth caused by baby boomers is ending, the forces acting today will unwind eventually. Put simply, we're dealing with lower for longer, not lower forever.

Even so, these processes act so slowly that we must adapt to them today. We cannot just sit back and wait for these slow-moving forces to reverse. People and companies, investors and savers, all need to understand these forces and make adjustments.

Lower for Longer and Savers

One group that has certainly been affected by lower for longer is savers, particularly seniors who planned to finance their retirement with interest income generated by a life of working hard to build savings. I have heard from many Canadians who are rightly worried about their ability to live off their savings and who are seeking a return to higher interest rates.

I certainly can sympathize and understand these concerns. Demographic and economic changes, along with the low interest rates that followed the financial crisis, have upended the calculations that many Canadians made in planning for retirement. That is not their fault.

But at the heart of this discussion is the level of the real rate of interest. Having higher nominal interest rates because of higher inflation would not help savers, because higher inflation would just erode the future purchasing power of those savings. Maintaining a low-inflation environment is the Bank's primary goal. We do this because we've seen that it is the best way to help bring about solid, sustainable economic growth. That growth benefits everyone, from business owners looking to expand, to workers looking for employment, to savers looking to protect their savings and find investment opportunities.

In our most recent *Monetary Policy Report*, in July, we said that our current policy rate setting of 0.5 per cent was consistent with the economy returning to full capacity toward the end of 2017 and inflation returning sustainably to its target. We'll update our forecast next month, but in our decision on September 7, we indicated that the risks to our projected inflation profile have tilted somewhat to the downside following recent data on investment in both the United States and Canada, and the recent data on our exports. It is quite evident that our economy is still facing strong headwinds, and we need stimulative monetary policy to counteract them and move us closer to full capacity. We also need to watch the full effects of the government's fiscal stimulus unfold.

However, the decline in the real neutral rate means that any given setting of our policy rate will be less stimulative today than it was a decade or two ago. The current policy rate, while certainly providing monetary stimulus, is not as stimulative as it would have been before the crisis.

By the same token, an immediate rise in our policy rate back to, for example, the 4.25 per cent that prevailed before the financial crisis would represent an extreme tightening of policy and would have significant consequences. This is just another way of saying that low interest rates are actually having big effects today, but the headwinds pushing back on that stimulus remain quite powerful.

For some savers, ultra-low interest rates do have positive effects. In particular, the value of most assets rises when interest rates decline, supporting gains in household wealth. This effect may not be as obvious as the impact of low rates on savings. But lower interest rates generally mean higher stock and bond prices, as well as increases in the value of real estate, which has been another important source of wealth for many savers, particularly seniors.

I realize this may be cold comfort to those people who have to adjust retirement plans to a lower-for-longer world. But the difficult reality is that savers must adjust their plans. That may mean some combination of putting aside more funds, working a little longer than planned or changing the mix of investments. There are no easy answers, particularly for some who have already retired.

Compounding the challenge is the fact that people are now living longer—life expectancy has risen by about 6 years since the early 1980s. I hope you will agree that this is unambiguously good news. But combining longer life expectancy with low interest rates means that a person starting to save today would have to set aside much more to generate the same retirement income as a person who began saving 25 years ago, if both wished to retire at the same age.

Lower for Longer and Companies

The other group I would like to talk about today is companies and, specifically, their decisions about business investment. Across the global economy, investment spending fell sharply during the financial crisis, and the recovery has been unexpectedly weak. The recent drop in oil and other commodity prices has lowered investment plans even further.

When investment slows, it means an economy's potential output also grows more slowly, which can reinforce the trend toward lower interest rates. In contrast, raising potential output through increased investment can ease the downward pressure on global rates.

With interest rates as low as they have been, the cost of capital certainly is not a problem for well-established businesses. But as economists, we know that credit provision will always be less than perfect in a financial system such as our own. And there is a risk that changes to global banking regulation, designed to make the system safer, could worsen any such imperfections. Put another way, it is likely that financing gaps continue to exist—and could easily have increased in importance—for new and young businesses, for small and medium-sized enterprises, and for trade finance and infrastructure. Given the importance of young company growth at this stage of the business cycle, the Bank is monitoring data on company formation and credit flows carefully.

Still, we are seeing a number of firms in Canada's non-resource sector that are operating close to full capacity. Under normal circumstances, you would expect investment intentions to be rising, but so far that has not really been the case.

Research done at the Bank of Canada and elsewhere, including conversations with business leaders, suggests that the main cause of weak investment is the high level of uncertainty that companies are facing, particularly about future demand prospects.

And it is understandable that businesses would be uncertain. Companies have lived through the daunting experience of the financial crisis and Great Recession. On top of that, we have had all sorts of economic and geopolitical uncertainties across the global economy. In such an atmosphere, it's not surprising that business leaders would be reluctant to commit to major new investments.

However, in my conversations with Canadian firms I have picked up on another possible investment impediment—hurdle rates for new investments do not seem to have adjusted to the new reality.

The hurdle rate is the lowest acceptable rate of return that a company chooses for an investment to proceed. Generally, you calculate the hurdle rate by adding together the risk-free interest rate, a measure of inflation expectations over the life of the project and a premium to compensate for the investment's risk. Because the risk-free interest rate is closely related to the real neutral rate, and because the real neutral rate has been declining, it follows that hurdle rates should also be lower, all else being equal.

I have had some business leaders tell me that they have been surprised to see, for example, companies in Asia pursuing investments with implicit returns of around 3 to 4 per cent, well below most companies' hurdle rates. My response has been to say that in the current and prospective environment, 4 per cent will probably turn out to be a pretty good return.

If uncertainty is the main impediment to investment decisions, then it should subside over time as economies heal, improving the investment climate. But if companies are maintaining traditional hurdle rates, they are unlikely to invest any time soon, and we will not see the kind of growth, productivity and job creation we are looking for. And neither will the companies.

Policy Prescriptions

So far, we've talked about the adjustments that are needed in response to powerful, slow-moving global forces. We know that these forces have reduced the real neutral interest rate here in Canada and will keep the growth of potential output around 1.5 per cent for the next number of years.

In such a context, increasing potential output growth by even a few tenths of a percentage point would make an important difference to all the issues I have spoken about today. Raising potential output growth would boost the real neutral rate of interest and long-term interest rates, and it would increase returns on investments for savers and companies alike. So if there are policies that would boost potential output—the sum of labour force growth and productivity growth—then we need to pursue them.

Fortunately, there are many things that we collectively can do. The G20 has been discussing this for some time, describing it as the third leg of the policy stool—structural reforms to complement monetary and fiscal policies.

Here in Canada, one way forward is to identify and remove impediments to business growth. For example, new and young firms are often the ones that can do the most to improve an economy's productivity, create new jobs and raise potential output. So we need to make sure that our tax and immigration policies, as well as our ability to finance growth of young firms, are as enabling as they can be, so we can nurture those firms and see them flourish right here.

One important impediment to business growth that is widely shared globally is weak infrastructure. We know that infrastructure projects spur growth in the short term by boosting demand. More importantly, infrastructure projects can support long-term growth by raising an economy's potential output.

Among economists, there has been some debate over the size of the impact on potential output that infrastructure projects can deliver. Deputy Governor Sylvain Leduc did some research during his time at the Federal Reserve Bank of

San Francisco. The research showed that, within six to eight years, US government spending on highway projects delivered at least one dollar, possibly two to three dollars, in increased output for every dollar spent. It would be helpful to have more research on the fiscal multipliers of infrastructure spending in Canada. But it seems likely to me that well-targeted infrastructure investments will yield more economic growth than just the first infusion of cash because they enable more growth to occur in the future.

Another key avenue shared by all economies is trade liberalization. We all need to encourage this, both within Canada and internationally, since the world seems to be entering a phase of doubt about the benefits of international trade. Beyond the rhetoric, the future of the Trans-Pacific Partnership (TPP) has come into question, and the trade agreement between Canada and the European Union, while much more advanced, still must go through a long ratification process. We know from history that sliding into protectionism would be highly counterproductive. It is important for authorities to continually make the case for freer trade.

Here at home, the announcement this summer of a preliminary agreement on interprovincial free trade is certainly welcome. There are many indications that interprovincial barriers are holding back the growth of individual companies and the economy as a whole.

It is also important to recognize and understand the reasons behind rising anti-globalization sentiment. For example, people who have been affected by restructuring brought about by globalization often face difficult adjustments, including retraining and moving long distances. Policy-makers need to be sensitive to these difficulties and do what they can to facilitate those adjustments.

At the same time, there is a role for economists to do compelling research that reminds people of the impact of trade. Increasing trade is a positive-sum game. Companies, too, could do more to demonstrate how globalization has made all kinds of goods and services more widely available at a lower cost, and how important trade is for their own employees.

Making infrastructure investments, defending existing trade arrangements and pursuing new ones are certainly good candidates for boosting Canada's economic potential. But when we move from theory to practice, how big can those effects be?

Well, bearing in mind that we start our analysis with a projection that Canada's economic potential is likely to grow by only around 1.5 per cent, which is not very inspiring, we need to take every decimal point of potential growth more seriously than we have in the past. Now, none of the structural initiatives I've mentioned is a silver bullet by itself. But together, they could make a large difference in our long-term economic prospects. Let's consider the possibilities in light of existing empirical evidence.

Begin with the removal of interprovincial trade barriers. Conservative estimates suggest that removing interprovincial trade barriers could add one- or two-tenths of a percentage point to Canada's potential output annually. Some estimates are far larger.

As for international trade, research conducted at the World Bank and elsewhere suggests that the TPP could add a further one- or two-tenths to our potential output growth. The Canada–EU trade agreement should also boost potential, though estimates suggest by less than the TPP.

In a low-growth world, these three initiatives taken together could have a significant impact on economic growth, year after year. Now, let's add the impact of targeted infrastructure spending. A prudent estimate is that this could add another tenth or two of a percentage point to potential output over the medium term.

When you consider how the benefits of these policies would add up over years, you'll see why every decimal point counts. A reasonable estimate is that these policies could raise the level of real GDP by 3 to 5 per cent by 2025, which would mean up to $100 billion more in income for Canadians every year. In a lower-for-longer world, these are opportunities we simply cannot afford to miss. This is especially true because other countries are not sitting still—in other words, we could actually lose ground as other countries become more competitive, so failing to take up these structural opportunities might still mean an erosion of the status quo.

Conclusion

It's time to conclude. What I've tried to do today is be clear about the forces that have brought about this period of ultra-low interest rates and help identify the implications. While monetary policy actions played a role in the decline of interest rates, the Bank sets its policy rate to meet its primary mission: returning inflation sustainably to target, thus helping to get the economy back to full output. In this sense, ultra-low interest rates are a symptom of the conditions we face, conditions that we believe are improving over time.

But some of the forces leading to low interest rates will persist for a long time, so we need to prepare for lower for longer. Individuals need to plan for retirement with different assumptions about longevity, interest rates and growth. Businesses need to make sure their expectations about investment returns reflect the current and likely future reality and reconfigure their investment plans accordingly. And policy-makers need to make sure they are working to increase the economy's potential output and reduce uncertainty—whether economic, political or regulatory—that may be holding back investment.

What the Bank can, and will, continue to do is to provide certainty about the future value of money through inflation control. Together, we can make the necessary adjustments and boost confidence that will foster the economic growth we all want to see.